US Agency for International Development
Study of Innovative Practices in SME Finance

Case Study: American Bank of Kosovo

Building and Selling a Commercial Bank

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Background

This paper is part of a six-study series that was conducted by the U.S. Agency for International Development (USAID), with assistance from Deloitte Touche Tohmatsu. The purpose of the study series is to identify and document innovative practices in SME financing. The information for this study was obtained from on-site visits and interviews with management of each of the organizations. The interviews were conducted by Suzanne Nolte Saunders of USAID's Economic Growth, Agriculture and Trade Bureau, Office of Economic Growth, with assistance from Teresa Mastrangelo of Deloitte Touche Tohmatsu for the Uganda and South Africa cases and from Maribeth Murphy of Deloitte Touche Tohmatsu for the Chile case. For more information on the overall series or to find the other study documents, please go to http://www.usaid.gov/economic_growth/egat/eg/tech-financial

Acknowledgements

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List of Selected Interviews:

- Lawrence Camp, USAID/Washington
- Paul Davis, USAID/Pristina
- Merita Emini, USAID/Pristina
- Arelis Gomez, International Management and Communications Corporation
- Alan Pieper, Deloitte Touche Tohmatsu

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I. Introduction

Kosovo Business Finance (KBF) is a United States Agency for International Development (USAID) funded activity designed to provide quick-disbursing financing to Kosovar businesses in the aftermath of the NATO/Serbia conflict in 1999. This activity is notable for five reasons, it demonstrates:

- The ability of USAID to create successful public-private partnerships that can achieve USG development objectives while simultaneously meeting private sector commercial objectives
- That quick-disbursing lending programs in unstable and underdeveloped environments can be viable (acceptably low levels of loan loss), but they require a significantly different approach to lending and loan administration
- That domestic savings can be rapidly mobilized and redeployed to domestic investments and loans
- The advantages of establishing a formal, full-service bank rather than a pure lending program
- The value of subsidizing organizational infrastructure and human capital rather than pricing structure

KBF is a three-year program. The first year of this project entailed two parallel initiatives: the development of a lending operation and creation of a bank, American Bank of Kosovo (ABK). The second focused on the merger of the two operations under ABK and growing ABK. The third year is oriented towards the sale of ABK to a major Western commercial bank.

This study documents why the USAID mission chose to develop a full-service bank from the ground up, describes the philosophy behind the financing program, and outlines the lending program approach. It covers how USAID structured the separate loan and bank entities, the subsequent consolidation of the two operations, and some of the accomplishments of the consolidated entity. The case covers the progress of the project in its provision of credit to small and medium enterprises (SMEs[1]), in its demonstration of how SME lending can be commercially viable, and in its success of mobilizing domestic savings in a troubled economy. Because of the uniqueness of the Kosovar situation, the study also highlights some key attributes of the local Kosovar environment that will impact on the success of the initiative.

II. Background and Goals

The province of Kosovo suffered from a decade of discrimination and neglect, and was further ravaged in 1999 by the Serb occupation and "ethnic cleansing." During the 1999 conflict, almost half the population of Kosovo fled their homes, almost half of the housing stock was damaged or destroyed, most medium and large businesses were idled, and significant damage was inflicted upon infrastructure and industrial capacity.

[1] Defined using World Bank definition for business size: small business, 6-20 employees, and medium business, 21-250 employees.

Unemployment as reported by the United Nations Development Program was massive and in excess of 50 percent, indicating the urgent need to get people back to work and get businesses operating again.[2]

USAID developed the Kosovo Employment Generation (KEG) program to stimulate employment and increase private investment in the SME sector in Kosovo. KEG is composed of two distinct but coordinated initiatives, Kosovo Business Finance and Kosovo Business Support (KBS). The goal of Kosovo Business Finance is to support the recovery and revitalization of small and medium enterprises in Kosovo by providing a SME credit facility and establishing a full-service bank in Kosovo. Kosovo Business Support is a complementary program designed to directly assist Kosovar SMEs to revitalize and improve operations through assistance in four areas:

1. Support SMEs with high potential for rapid growth and employment generation to establish or improve competency in key functional areas
2. Support SMEs in financial distress with turnaround and crisis management measures.
3. Support the broader business community through training programs, sectoral analyses, initiation of trade and investment linkages, and dissemination of performance improvement resources
4. Develop a cadre of Kosovar accountants and consultants to provide on-going business support services

Although this case addresses only the Kosovo Business Finance component of the umbrella employment program, the presence of a concurrent business support program results from the recognition that many SMEs need more than finance. They need to further develop their basic business skills and, on an ongoing basis, to have access to a community of service providers. The two programs working side by side mutually reinforce each other – KBS by strengthening the operating performance of loan clients and KBF by providing financing for creditworthy KBS consulting clients. The complementarity of the two programs resulted in 180 clients from the KBS becoming clients of ABK as of August 2002.

III. Program Highlights

Kosovo Business Finance commenced May 2001 as a three-year program undertaken with the support of Deloitte Touche Tohmatsu Emerging Markets, Ltd. (DTT). It entails:

- The development of a quick response SME credit facility, “the Loan Production Unit,” named the Kosovo Business Finance Fund or KBFF
- The development of a full-service licensed bank, the American Bank of Kosovo or ABK, into which the loan unit is merged
- Extensive technical assistance to develop the financial analysis and management capabilities of local bank professionals to yield post-program sustainability

[2] This information was taken from the Kosovo Employment Generation Program, Contract Statement of Work, Section C

Table 1: Program Support over Three Years

	USAID ($mm)	RIAS/ Rabobank
Capitalize Loan Fund	$ 5.0	
Capitalize Joint Stock Kosovar Bank (via KBFF)	$ 4.0	
Operate Loan Fund and Bank and Train Staff	$10.5	$50,000
Total USAID Investment	**$19.5**	
Staffing: Expatriates	1,950 person days	
Staffing: Local Hires	10,640 person days	

The loan fund has a $15 million ceiling of which only $5 million will be used.

The vision for the program is that the full-service bank is sold in part or in whole to a multinational bank, and some or all of the capital investment is recouped. At the time of writing, a tentative agreement has been reached with Raiffeisen Bank of Austria for a purchase price of roughly $15.5MM.

KBFF opened operations in June 2001 and the ABK in November 2001. As of April 30, 2002, the following results have been achieved:

Table 2: Financial Highlights of KBFF and ABK as of April 30, 2002[3]

KBFF Loans	**Number**	**Amount (EUR)**	**Average Amount (EUR)**	**Average Term (months)**	**Average Interest**
Disbursed	189	5.5 MM	9.4		15 percent
Closing finalized & pending disbursement	9	.7 MM		11.4	15 percent
In process of final Closing	31	.6 MM		10.1	15 percent
Total approved, and in process of final closing	229	6.8 MM	29,745	9.6	15 percent
Delinquent Loans	5				
# Loans Referred from KBS	50				
Expected New Jobs Created	1,131				
New Job/Loan Ratio	1 new job per EUR 6,414 in loans.				

[3] Current figures indicate that the robust performance trends are continuing. As of August 10, ABK had around Euro 28 M in deposits with 17,000 accounts opened. As of August 28, ABK has approved Euro 13.3 M in loans for 511 borrowers. 1 USD = 1.02 EUR

ABK					
New Accounts Opened	10,000	16.4 MM			

Source: ABK

As of April 30, there were five loans in arrears. All loans in arrears except one continue to make partial payments in cooperation with KBFF. One loan has been formally foreclosed and KBFF received a favorable legal settlement by the municipal judge ordering the borrower to fully repay by June 1, 2002.

IV. Program Preparation

In preparation for this significant undertaking, a diagnostic team from International Management and Communications Corporation (IMCC) analyzed the appropriateness of different options for SME financing. They relied on a World Bank report of March 2000 for some market data as well as on learning from prior donor efforts in the region. One important finding from this research was that the biggest gap in loan provision was in the EUR 20,000 to 50,000 range. The options examined are listed below, followed by further discussion on the applicability of each one.

Options Reviewed:

1. Setting up a separate legally self-contained SME financing facility.
2. Operating a SME credit facility through a licensed commercial or development bank.
3. Setting up a rediscount line financing facility for use by eligible licensed commercial banks.
4. Developing a loan guarantee facility.
5. Utilizing donor financial and/or technical resources to attract a viable regional or international banking institution into Kosovo.
6. Establishing an equity fund to provide venture capital to fledging private entrepreneurs.
7. Utilizing seed capital to attract reputable international or regional investors to set up and operate an equity fund operation in Kosovo.

USAID selected a combination of the first and fifth options – to set up a separate legally self-contained SME financing facility and utilize donor financial and technical resources to attract a viable regional or international banking institution into Kosovo. USAID's approach was to capitalize a full-service banking institution and a separate loan-financing unit. This loan-financing unit would provide the opportunity for USAID to train personnel and develop its own lending policies and procedures customized for SMEs and meet their demand for loans in the EUR 20,000 to 50,000 range. At the separate banking institution, USAID would develop basic financial management, information technology, and administrative control systems without having to simultaneously involve itself in complex loan analysis and administration functions. Once both operations are up and running, the loan portfolio would be integrated into the bank's operations and asset base. The ultimate goals of the separate development and subsequent combination of the two operations would be to:

- Expand the capital base of the bank

- Operate on a sustainable basis by using deposits to fund loans
- Demonstrate to other banks in the financial system that a well managed SME lending portfolio is both consistent with, and effectively contributes to, strong commercial bank financial performance

A potential alternative to the selected approach would have been to participate in a similar SME lending program already in place by the World Bank. USAID decided not to go this route because the program excluded the target loan demand group (World Bank's range is EUR 50,000 to 150,000), and USAID would not be able to implement the loan and monitoring procedures it deemed necessary for such a program. In addition, this program lacked the core element of sustainability incorporated into the design of the USAID program through the targeted merging of the loan portfolio into a full service banking institution.

Options two and three were not pursued because of the lack of licensed banks to work through and, because of the extended period required before the local banks would receive licenses and be in a position to manage a SME credit or rediscount facility. At that point in time, there was one licensed bank, Micro Enterprise Bank (MEB) which had been established in late 1999 as a joint initiative of IFC, the European Bank for Reconstruction and Development (EBRD), and Internationale Projekt Consult. At the time of planning, this bank was not targeting the SME sector for its credit services.

Option four, the use of a loan guarantee, was not used primarily because Kosovo lacked well-developed financial intermediaries and the legal infrastructure for loan guarantees. The initial analysis of options also included concerns that loan guarantee programs can add administrative costs, are not market based, and do not often have the proper incentive system for loan recovery.

Option five to attract a viable regional or international bank to Kosovo was considered a desirable outcome, but was determined not to be viable as a stand alone strategy. The Kosovo market would appeal to banks because of the significant unsatisfied demand for deposit services. However, lending to SMEs in Kosovo would still be considered risky because of the absence of traditional guarantees, contract enforcement mechanisms and, in most cases, credible financial statements. Therefore, if a foreign bank did enter Kosovo, it is more likely that they would capture deposits and invest them in low risk financial instruments abroad than lend them to SMEs. The presence of a trailblazer to develop SME lending technologies that can generate a profit was needed to demonstrate that the Kosovo market would be worth entering.

Option six and seven both relate to venture capital for which the legal and enforcement infrastructure is not yet in place. In addition, SMEs in Kosovo are often owned by groups of family members. The diagnostic team noted that in other parts of the world, outsiders find it difficult to invest in such family groups. An additional option that is not listed above and that may be more attractive than venture capital is leasing. However, this will also depend on further development of the local banks and legal environment.

V. Local Environment

In studying the KBFF, it is particularly important to look at the initiative in the context of the local environment. Most of the environmental factors below have influenced the design of the program while others will either contribute to its success or pose future challenges.

Positive Environmental Factors:

- A dynamic entrepreneurial sector which is well educated and profit-motivated exists, even though that has been suppressed over the last decade.
- The unique political status of Kosovo as a United Nations protectorate has facilitated progress toward a stable banking regulatory environment.
- There exists pent up need for safe institution in which to place savings - an estimated 90 percent of funds deemed “mattress” money in 2000.
- The Euro conversion requirement at December 31, 2001 caused a large influx of foreign currency (DM) savings into the banking system.
- Kosovars have positive attitudes to western commercial banks stemming from experiences of relatives abroad.
- The DM/Euro denominated economy avoids the devaluation risk of a local soft currency and minimizes conversion transactions costs.
- There is higher demand for products of SMEs fueled by presence of 70,000 ex-patriots and their economic reconstruction programs (although this demand supports trade and services over production).
- Kosovars have a very strong loyalty to the U.S.A. and confidence in U.S. institutions.

Negative Environmental Factors:

- Kosovars have distrust in the local banking system from losses or confiscation of savings.
- Borrowers have little or no credit history.
- Many businesses operate with obsolete equipment.
- Limited reliable financial information is available for businesses due to the lack of skills and of adherence to international accounting standards.
- Inconsistencies exist in registry and property titling systems between what people claim they own and what is reflected.
- The legal infrastructure is undeveloped, particularly with regard to enforcing contracts.

VI. Program Philosophy

The design of the Kosovo Business Finance Program is largely driven by the assumption that the processes and technologies used in microfinance are also applicable to financing for small and medium businesses. Specifically:

- The most important evaluation criteria are the potential client’s character and business acumen.

- Reliance on financials is based more on discussions with clients and reviews of their operations than on formal financial statements.
- Clients make their loan repayments when their reputation and family home is at stake and when they are receiving frequent visits by loan officers.
- Larger sized loans and longer maturities are only extended after the clients have developed a good record of servicing smaller loans.

VII. Lending Program Approach

See below some of the specifics around the lending operation, such as the terms, targets, and application process, as well as a description of some key procedures for credit risk management and internal control.

Table 3: Loan Terms

Target loan size	EUR 25,000 – 200,000; average EUR 29,745
Loan types	Working capital and fixed asset loans -- only working capital to first time borrowers
Maturity	6-36 months; average 9.6 months
Interest Rate	Fixed at 14 – 18 percent per annum; average 15 percent
Repayment	Monthly on the 10th or 25th

Table 4: Two Tier Interest Rate System
(Based on Kosovo Market Rates)

	1 year loan	2 year loan	3 year loan
1st Time Borrower	15-16%	17%	18%
Repeat Borrower	14%	15%	16%

Targeted Lending:

- Target manufacturing and production sectors in order to generate maximum employment.
- Include employment generation as primary criteria for lending due to the critical unemployment situation (estimated at around 50 percent).
- Only lend to 100 percent privately owned businesses that are at least 51 percent Kosovar owned.
- Serve the minority Serb population through opening offices in Serbian enclaves, current plans include opening four of these offices.
- Only lend to companies registered by UNMIK (the vast majority of companies).

- Target companies with at least two years of direct or complementary experience in the business activity; loans for business startups require the submission of a detailed business plan.
- Review status of actual versus planned jobs created during customer visits to check actual versus planned business growth.

In accordance with the project goals for employment generation and economic stimulation, ABK's lending priority is to finance businesses engaged in labor-intensive manufacturing and production activities. Of the 251 loan applications that were approved by the project, 92.8 percent are in the manufacturing/production industry sector, 5.6 percent in the service industry sector and 1.6 percent are engaged in pure trade. A breakdown of the loan portfolio by industry sector is shown below.

Table 5: Sectors to Which the Loans Are Extended
As of April, 30, 2002

Industry Sector	Amount (000s Euro)		# of Loans	
Manufacturing and Production	6,700	92 %	233	93%
Trade	306	6 %	4	2%
Services	295	4 %	14	6%

Of the 251 loans approved, 19 percent are to borrowers within the Pristina municipality, 14 percent in Prizren and 6 percent in each municipality of Ferizaj and Gjakove municipalities. Lending activity in the minority regions of Kosovo has also been a priority of the lending team, as is evident by the increase in number of loans generated in these areas.

Application and Approval Process

The application process for first time borrowers has been reduced to a month, and should only require additional time if the loan officers encounter complications in the obtaining the pledge collateral information. For repeat borrowers, the process can be reduced to as short as 48 hours. The approval process benefits from having independent review by two committees. During both review processes the managers who are responsible for supervising the loan officers that have put forth loans for review are excluded from determining whether the loan is approved.

Table 6: Loan Application Timeline

General Timeline	Week #	Process Step
First week	Week 1	Client and loan officer complete application
Friday, following application completion	Week 1	KBFF credit committee approves (or rejects) loan in weekly Friday meeting
Monday, following KBFF meeting	Week 2	USAID credit committee approves loan in weekly Monday meeting
One week after loan is approved	Week 3	KBFF prepares loan documents
One week after loan documents are prepared	Week 4	Loan closing takes place

Lending documentation:

- Screening Application
- Loan Recommendation Form
- Loan Collateral Form – with registration and title documents attached
- Applicant's Bank, Liabilities and References Schedule

Procedures to Manage Credit Risk:

- Conduct first interview on business premises to get a hands-on view of the business.
- Develop a balance sheet and cash flow statement in English in conjunction with the client.
- Cap virtually all first-time loans at Euro 65,000, limit them to working capital and charge higher interest rates than on repeat loans.
- Secure virtually all loans through a mortgage on land/building and also through pledges on moveable property registered through the recently established and USAID supported Pledge Filing Office..
- Monitor loans through customer visits four times a month in Pristina and three times a month outside of Pristina.
- Require at least three non-family character references, which ideally include suppliers, clients and other business and community associates.
- Require monthly repayments on the 10th and/or 25th of each month

The above procedures to manage credit risk are complemented by a host of internal controls and procedures. Two notable control mechanisms include:

1. Send credit administrators on alternating visits to customers to control for any misappropriations of funds.
2. Set up a credit review department separate from credit administration to add an internal control function to the loan process and tracking function.

Training

Extensive training is provided to new recruits through formal classroom training, continuous on-the-job training, and specialized workshops and seminars. Training for the lending personnel has evolved over the year to include:

- Credit risk management, financial statement analysis, cash flow analysis and projections, SME business risk evaluation, business planning, client interaction, collateral valuation and loan monitoring
- Small and micro lending techniques
- Lending processes, including origination, disbursement, legal aspects, and document completion
- Relationship management, advanced loan collection techniques, loan restructuring, financial modeling, and industry analysis

These courses are complemented by the continuous mentoring between the loan associates and their supervisors and by cross training between the associates in front and back office functions. After the two operations were merged, additional training was provided to educate the lending team on all products and services offered by the ABK and to familiarize them with the sales process, so that they can effectively grow client relationships and increase deposits.

VIII. Legal Formats

USAID was interested in establishing KBFF as a legal entity that would afford USAID effective control and oversight, but separate USAID from the day-to-day operations of the unit. KBFF was established as a non-profit financial institution under United Nations Mission in Kosovo (UNMIK) regulation 1999/22 on June 18, 2001, making it an indigenous Kosovar institution. KBFF received approval to operate as a non-bank financial institution on June 21, 2001, and received a bank license from the Banking and Payments Authority of Kosovo (BPK) on July 19, 2001. The funding for KBFF was channeled from USAID via a letter of credit. The letter of credit was set up by the Department of Health and Human Services, the U.S. government agency through which USG letters of credit are set up and maintained.

The ABK was established as a joint stock company on August 14, 2001 under UNMIK Regulation 2001/6, with KBFF owning 97 percent and Rabobank International Advisory Services (RIAS) owning 0.7 percent with an investment of $50,000. USAID's investment in the bank went through KBFF, enabling the bank to be a locally licensed institution. ABK received Tier III status from BPK in December 2001, which allows it to be a full-service financial institution, offering such additional services as pension management. RIAS was brought into the program to bring its banking expertise and to make its limited investment.

IX. American Bank of Kosovo

USAID created the American Bank of Kosovo (ABK), a local licensed bank, to attract a significant deposit base and eventually to absorb the loan fund. The goal of the bank is to supply customers with a full array of debt, depository, transfer and other services, and to pursue a proactive SME lending strategy and focus. The program plan was to integrate KBFF into the commercial banking institution once KBFF achieved its near-term objectives, making the two operations one self-sustaining institution. Ultimate sustainability is tied into USAID's exit strategy, which will entail the sales of USAID's ownership stake in the bank (possibly on a phased basis) to a major commercial banking institution.

Review of the bank in this case study was limited to the extent that it could take on the loans of KBFF and become a profitable full-service bank. ABK met with immediate success drawing deposits of EUR 13 million in the first month and a half of operation. It is acknowledged that deposit-taking performance was buttressed by the Euro conversion process. However, this success is an indicator of the extent of mattress money that exists in the region. Intensive training for the new local staff facilitated the ABK's rapid startup. The startup included some initial complications with the banking operating system, a customized version of Globus, which necessitated manual entry of transactions in the beginning months. However, meetings with the bank management in January 2002 indicated that the bank was moving from a crisis to a growth mode, solidifying internal processes and procedures, and transitioning from reactive customer management to a more proactive customer targeting.

As regards ABK's systems, further improvements are being made. After the loan portfolio was rolled into the bank, KBFF's internally developed Access database harder to use, yet the GLOBUS system does not yet have the appropriate software to support the portfolio. This problem is being addressed through the installation of the appropriate GLOBUS loan accounting software. In the interim, the Access database will be enhanced to support the higher volume of data. On a separate note, the ABK was able to develop and implement bulk payments software that reduced inputting time and errors.

X. Merging of KBFF into ABK, Personnel Management and Accomplishments

The merger of the operations began in January 2002 with the placement of the loan unit inside the physical premises of the ABK. Senior bank staff members are now part of the KBFF credit committee. As of April, KBFF was integrated as the lending department of ABK, with all staff becoming part of ABK and all existing performing loans transferred to ABK. The non-performing loans, five totaling Euro 240,000, were maintained at KBFF for collection or foreclosure. Three of these loans are in various stages of foreclosure and collection, and the management expects to be able to fully collect on them. For the other two loans, the management team filed criminal charges alleging the borrowers presented false information to KBFF. Arrest warrants were issued for the borrowers. KBFF management believes they will have to write off a large portion of these last two loans.

As part of the integration, reporting for both the credit and bank operations was streamlined, a plan was developed for integrating the loan tracking information into the Globus system, and cross-training staff was started. Some personnel information and achievements are listed below:

Personnel

As of June, 2002, the staffing of ABK included ten expatriates and 141 locals. Of the expatriates, four worked with the lending operations, five with the banking operation and one is the chief of party for the overall project. The local staff includes 27 people dedicated to lending and credit administration, 60 cashiers and customer relations managers, seven information technology personnel, 15 professionals filling various roles: human resources (1), office managers (2), legal advisor (1), finance/accounting (4), business analysts (2), payments (3), marketing (2), branch managers (3), and 18 support staff, cleaners and drivers.

HR Process

To support the merger, management created a Human Resources department and brought in a human resources manager. The HR manager's most immediate function was to assist with an aggressive recruitment plan for staffing and training personnel needed for the new branches opening during summer 2002. The HR manager's roles also included formalizing the HR policies, procedures, and records including personnel files, job descriptions, job grades, salary scales, performance reviews, and promotional procedures.

Branch Networking

At the time of writing, ABK had as a high priority the expansion of services through an expanded branch network. Meanwhile, the Central Bank of Kosovo (BPK) decided to sell off many of their branches. An ABK team was established to evaluate whether it would be more cost effective to expand through purchasing the BPK branches or by opening new branches. In April, the management team submitted a tender for six branches and five sub-branches offered by BPK. ABK won the tender and by close of June had established seven branches and eight sub branches throughout Kosovo.

New Products and Services

The ABK management team has explored and instituted additional services to its clientele, including direct deposits for payroll, different types of lending services, Automatic Teller Machines (ATM) and Debit card services. Following is a brief update on several of the initiatives that the bank is currently pursuing:

Direct Deposits for Payroll:

During March and April 2002, ABK made arrangements with public entities to electronically transfer payroll funds to its employees that bank with ABK. Although this resulted in a substantial increase in accounts of government employees, it also caused an unexpected surge in withdrawals the day after payday. To ensure adequate customer service during these high traffic days, several tellers are added and the cash handling requirements are streamlined. With this increased efficiency, ABK will continue to pursue the acquisition of clients through the provision of payroll deposit services.

ATM/Debit Card Services

During the month of April, the team began working on the ATM implementation plan. Research was conducted to determine exact costs and revenues associated with each machine and USAID directed the team to order and purchase six machines for placement in strategic locations. The machines are expected to be operational by November.

Mobile Banking Services

An application for the banking license for the Mobile Banking Services was completed and submitted to the BPK in March. During April, the team focused on finalizing the management plans, finding a suitable location in the minority areas and hiring and training staff to work the branches. Upon approval of the license, full mobile banking operations began in the Serbian areas mobile banking during the month of May. At the time of writing, those mobile branchs are now being supplanted by operating branches.

Marketing and Sales Team

A marketing department was assembled in April to increase the deposit level and customer base of the ABK. The team identified four market segments and refined the strategy to gain market share. These targets are: 1) Large Domestic Businesses, 2) International and State-Owned Businesses, 3) SMEs, and 4) Small Savers. In May, an advertising campaign was to be launched to target these individual segments.

A sales team was created by selecting interested lending associates to sell new products to current SME loan clients and build relationships with new clients. A database was created to manage the lists of potential clients from existing SME's, NGO's, and large national and international organizations operating in Kosovo. The sales team went through training in April and is expected to begin generating sales leads through May.

One of the side effects of ABK's achievements is a recent increase in focus by MEB on the SME market. At the time of writing this study, it appeared that MEB was extending more loans to SMEs, adjusting their fees to better compete with ABK, and beginning to expand their services to cover a broader range of lending products.

XI. Program Sustainability

When assessing the sustainability of the bank/KBFF combination, much of it will depend on the continuity and leadership of the management team and on the exit strategy. If USAID is successful in selling the bank to a multinational bank, the sustainability of the operation will depend on the multinational bank's management team and approach. Regardless, some of the sustainability challenges are listed below:

Challenge	Description	Strategies to Address Challenge
Personnel	To ensure longevity of the program, local banking experts will need to be groomed and a few expatriate bankers will need to stay medium-term in Kosovo. There has been considerable turnover of management of the bank and loan operations, and the availability of local qualified staff is limited.	The program has a strong training curriculum to develop local managers. In addition, the rigorous selection process for expatriate bank management has ensured strong bank management staffing. If an international bank invests in ABK, it is expected that it will reinforce the required managerial achievements.
Profitability and Growth	The combined bank will need to aggressively expand the provision of financial services and increase fee and interest income to cover the currently subsidized costs. Operating costs are funded by USAID for the program term.	USAID and DTT management are developing a long-term pricing and marketing strategy to gradually increase fees. This will involve a transition from largely cost-based marketing to value-added marketing, as the bank learns more about its customer needs and can outperform competitors' (MEB) terms of customer service, product variety, and transaction time. An example is the internationally-linked ATM network in Kosovo during CY 2002, which is currently not available. On the loan side, growth is being generated by the policy that loan officers start selling subsequent loans to clients with strong repayment history and growth prospects about halfway through their repayment term. On the banking side, management is developing more of a proactive market penetration strategy, particularly targeted at larger customers as a strong source of fee income and a diversification move.
Privatization and Mission Continuity	Once the joint banking/credit operation demonstrates that it is profitable to service SMEs with lending as well as other basic banking services, how will USAID sell its stake in the operation? How will USAID ensure that the subsequent owners maintain lending services to the SME market rather than invest deposits in less risky government instruments?	USAID plans to negotiate an agreement with a major international commercial banking institution for its stake in the ABK, after having established a demonstrably viable banking operation. This could occur on a time-phased basis. USAID will establish covenants which support the continuation of a proactive SME lending strategy during the phase-out of its ownership stake. USAID hopes that by

	Once the operation is privatized, with deposits becoming the source of loan capital instead of donor funds, are there strong enough internal controls, prudential norms and banking laws to ensure that local deposits are not at risk?	achieving profitability, grooming experienced staff, and building an efficient and cost-effective SME lending system, they have created enough reason for a commercial banking institution to continue serving SMEs once it assumes ownership of the ABK. In addition, a demonstrated commitment to SME lending on the part of prospective purchasers will be one of the factors taken into account by USAID during this process.
Governance	The current board directors of the bank are all affiliated with the financing program, either from DTT or RIAS/Rabobank. Going forward, it would be beneficial to diversify the board away from the program management staff and to include some Kosovars.	Participation of officials from the financing program on the Board is vital for purposes of maintaining a strong SME lending focus as the lending program is absorbed into the ABK. However, the addition of qualified and independent board members will still need to be solved for even with investment by an international bank.

XII. Commentary on Program

Dedicated Staff

This program has benefited from having committed, creative USAID staff involved from the start in the diagnostic process. They developed a cohesive vision and defined aggressive plans for the achievement of benchmarks and tangible results. The USAID staff supporting the program includes one full-time Foreign Service National (about 50 percent of her time, ongoing), one Foreign Service Supervisor (about 30 percent of his time over the last year; 20 percent of his time ongoing), and a senior private sector officer in Washington, DC (about six months at the beginning). In addition, the Mission Director was a champion for the program, and together with the supervisor, developed a well-defined long-term vision for how the initiative should progress. Among the contractors, the senior credit manager of KBFF and a microfinance expert have been with the program from its inception. There has been turnover at the senior management level of the bank and lending operation, but the contractor has been very responsive in securing new personnel and bridging leadership with other contractor staff. The contracted staff have been active partners in designing and creating both of the new businesses, adapting to new challenges, developing, and refining processes to better serve local clientele and adapt to local constraints. The presence of the microfinance expert was helpful to incorporate micro lending techniques into the credit processes.

Learning from Past Efforts

Important to this program was the thorough review of the market conditions for SME financial services by a diagnostic team before the contract was issued. This review included analysis of the World Bank Report from 2000, studies of other financing programs that had already been set up and had gained valuable learning about the Kosovo market, and lengthy discussions on how to apply the fundamentals of microfinance in Kosovo. The review enabled the team to learn from past mistakes, better understand the needs of their target SME clients, and customize the program and products to meets those needs.

XIII. Conclusion

This case presents an initiative that is successfully increasing access to financing SMEs, using credit processes more reflective of microfinance than of traditional commercial banking. The parallel development approach of the loan operation and bank has been effective in ensuring the development of skills, processes, and procedures that are specialized to the different functions, respectively. In addition, given the high level of demand for a safe place for place deposits, the ability of the bank to self-fund loans is substantial, especially when compared to markets where savings vehicles are more prevalent.

Still, there are some key questions outstanding. One major one is whether, over time, the bank will generate enough revenue to fund salaries and other operating costs, most of which are currently being covered by USAID. Related to this, will the Kosovars buy into loan and deposit products that carry market rates rather than subsidized rates? Or, will the bank continue to use such a time-intensive credit management process when it is under private ownership and has a stronger profit motivation?

Regardless of how the above questions are answered, benefits have already emanated from the project:

- SMEs are receiving significant levels of credit to use to grow their businesses.
- Depository and transfer services are more available to the Kosovar population.
- ABK has demonstrated that SMEs are creditworthy, that there are effective and efficient ways to assess their credit risk, and that they have a substantial demand for credit.

Given that USAID is in discussions with a multinational bank to purchase a stake in ABK after only a year and a half, there is good reason to believe that the project was successful in its demonstration goal. This is also evidenced by the increased focus by MEB on the SME market. Furthermore, when considering the new services ABK is offering in addition to basic credit and banking services, it is clear that ABK continues to be a strong catalyst in furthering the development of Kosovo’s financial sector.

Postscript:
Sale of American Bank of Kosovo (ABK) To Raiffeisen Zentral Bank (RZB)[4]

As noted in this case study, the vision for the KBF program is that the ABK be sold in part or in whole to a multinational bank, and some or all of the capital investment is recouped. This vision became a reality in December 2002. In early 2002, Raiffeisen Zentral Bank (RZB) began to express a strong interest in acquiring a share in the ABK. RZB is one of Austria's two leading banks with corporate banking, retail and other services throughout Austria. RZB considers Central, Eastern and Southeastern Europe as core banking markets in its business strategy. They have successfully opened and operated banking subsidiaries in Romania, Bulgaria, Poland, the Czech Republic, Slovakia, Hungary, Poland, and Ukraine, and have recently established banks throughout former Yugoslavia.

With an eye to expanding its banking network in the region, RZB visited Kosovo in March 2002 and met with USAID representatives, ABK senior management (expatriates under the KBF project) and other relevant entities (e.g. the Banking and Payments Authority of Kosovo, BPK). After subsequent visits to the ABK by RZB, in August 2002 formal discussions and negotiations among the parties began. RZB is actually the majority shareholder of Raiffeisen International Beteiligungs AG and negotiated on its behalf, while the Kosovo Business Finance Fund (KBFF) was the majority shareholder of the ABK and consistent with its mandate, represented USAID's interests in bank sale negotiations. On December 10, the KBFF and RIB signed the "Sales and Purchase Agreement" whereby RIB purchased 76 percent of the ABK's capital stock. USAID, through the KBFF, will continue as a 24 percent shareholder in the American Bank of Kosovo. (KBFF had purchased RIAS shares in the ABK during the sale process and RIAS no longer owns stock in the ABK). The sale of a majority stake in ABK to RZB exceeds the benchmark set by USAID for Year 3 of the project, which was to have a reputable foreign financial institution own 50% of the bank.

USAID was substantially involved in the sales negotiations and its approval for KBFF to sign the sales documents was necessary for the transaction to be executed. The sales documents, particularly the Shareholder Agreement, reflect USAID's continued interest in ABK operations and strategy. For example, USAID, via KBFF, will have a representative on the ABK Board and while RIB will have day-to-day control over management of the bank, the consent of all ABK Board Directors is required for approval of items such as the bank's operating plan (including loan and deposit targets), the bank's operating budget and staffing of key management positions. Thus, in effect, USAID has "veto rights" over these items. These veto rights essentially remain in effect as long as USAID has a minimum 10% share in the ABK. In the Shareholder Agreement it is also stated that RZB will provide assistance to the Bank so that it is able to maintain a minimum of seven branches throughout Kosovo and that the assistance will be at a minimum: (1) sufficient to provide competitive banking services to northern Kosovo's ethnic minority area; (2) sufficient to provide competitively priced banking services throughout Kosovo on a non-discriminatory basis; and (3) sufficient to compete for social

[4] Written by Veronica Gilbert, Deloitte Touche Tohmatsu, January 30, 2003.

welfare and pension payment services throughout Kosovo. All of these items reflect USAID priorities in Kosovo.

Another innovative aspect of the sale is that the sale (and purchase) price included the provision of technical assistance through the KBF project contract with Deloitte Touche Tohmatsu. USAID intends to fund seven positions within ABK from the date of the sales agreement (December 10, 2002) through May 10, 2004, which is the KBF contract completion date. These positions, all subject to availability of funding, include: Chief Executive Officer, Chief Financial Officer, Business Development Manager, one IT specialist and 3 Credit and Loan Administration specialists. In addition, subject to availability of funding, USAID will fund the position of Chief Credit Administration Officer until May 10, 2003 and provide and fund up to eleven additional person months for short-term support to the ABK until May 10, 2004.

Reference List

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Authors Notes

1. I wrote this report in February 2002 and updated it in March and August 2002. As the project is moving swiftly along and has generated good momentum, much of the data and information will be quickly outdated. However, the innovative approach of this project and philosophy behind it are elements that will not change much with time and that will hopefully be of value to people designing new programs to increase bank lending to SMEs.
2. The USAID mission only undertook this program after they and other donors had kicked off programs to establish a sound macroeconomic policy environment, put in place a market-oriented commercial law framework, and carried out significant financial sector reform and legal and regulatory reform.